However, now that MFS has gotten what it wanted (lower LEC interconnection rates and mandatory physical collocation in CC Docket No. 91-141), and it is the BOCs who need access reform to compete evenly with such collocated CAPs, MFS sings an entirely different, laggardly tune. Now, four years later not only is MFS unable to present a "detailed proposal" for access charge and universal service reform, but actually professes to be unable to do anything more than suggest mere Commission "inquiries" into these subject areas.[34] Further, for some reason MFS now insists that universal service and access reform must be addressed separately, and the former before (rather than simultaneously with) the latter.[35] MFS is abusing the regulatory process by purposely advocating Commission procedures that are clearly unnecessary and will only delay greater ability of the LECs to compete with MFS through the much-needed access charge reform.

AT&T asserts that "most of the subsidy-related issues discussed by USTA" are either already being addressed or are about to be initiated.[36] It points to the Commission's indication that it is about to commence a comprehensive inquiry into Universal Service Fund (USF) issues and that the Commission is already

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[34] MFS, p. 2. See also, MFS' November 1, 1993 Petition for a Notice of Inquiry and En Banc Hearing on universal service.

[35] Id.

[36] AT&T, p. 8.

addressing support flows inherent in the local transport interconnection charge.[37]

SWBT disagrees with this assertion. The USF proceeding will most likely be limited to how the USF mechanism is applied and how it is funded. Even though AT&T adds that the proposed USF proceeding could include "all other explicit subsidies"[38] this still does not reflect the comprehensive review of universal service issues which is required to balance regulators' pro-competitive policies with continued universal service objectives. Furthermore, to the extent that limited universal service issues are being addressed, they are being addressed in a piece-meal fashion which USTA has demonstrated as ineffective and inefficient and which does not result in a coordinated solution.

A comprehensive initiative must examine broader issues such as an evaluation of a definition and objective for universal service and the methods and mechanisms required to efficiently achieve this objective in a competitive environment. This will require a much broader review than just "all other 'explicit' subsidies" as AT&T has asserted.

Despite varying opinions about universal service issues, there is general agreement that, to the extent required, support mechanisms should be broadly funded in a competitively neutral

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[37] Id., p. 9.

[38] Id.

manner.[39] As CompTel stated, "the mechanism for recovering legitimate subsidy amounts should not distort competition."[40] SWBT agrees with this premise.

In summary, SWBT supports the call for a broad examination of all universal service issues and believes that it could occur simultaneously with, access reform.[41]

VI. CONCLUSION

The objections advanced against the USTA proposed rulemaking proceeding are, in every case, unsupported, illogical, and/or impertinent. To have even a remote chance of keeping pace with the rapidly changing technological and market conditions

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[39] See for example, AT&T, p. 3; CompTel, pp. 4, 15; Sprint, p. 1; Ad Hoc, p. 3.

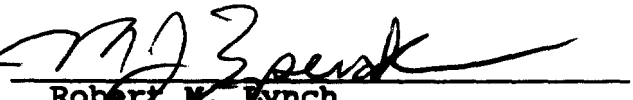
[40] CompTel, p. 15.

[41] This does not suggest that access reform should be delayed if the Commission is unwilling to initiate an examination of universal service issues at this time.

prevalent in our industry, thereby continuing to ensure that the public interest is met, the Commission should immediately issue a Notice of Proposed Rulemaking as recommended by USTA.

Respectfully submitted,

SOUTHWESTERN BELL TELEPHONE COMPANY

By 

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November 16, 1993

SWBT REPLY COMMENTS
RM-8356

THE CURRENT NATURE AND LEVEL OF COMPETITION FACED BY LECS FULLY WARRANTS THE ACTIONS PROPOSED BY USTA

The industry has undergone rapid and significant changes in technology and regulation during recent years which have rendered obsolete the fundamental basis for many of the access charge rules and which have led to increased competition in the interstate access services market.[1] LECs face strong competition from CAPs. These companies, with few exceptions, provide special access service via fiber networks in major metropolitan areas (New York, Chicago, Los Angeles, Houston, Dallas, etc.). CAPs today typically supply a dedicated connection between interexchange carriers and large end users, bypassing the LECs entirely. Unlike the manner in which the Commission regulates LECs, the Commission has not required CAPs to enter all markets, nor to serve all customers in the markets they enter. As a result, CAPs typically provide service to high-volume business customers in the densely populated business centers of major metropolitan areas, deploying lower cost fiber optic technologies that allow them to offer their services at substantial discounts below the LEC's geographically averaged tariffed rates.[2] Since access charges paid to LECs make

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[1] Federal Perspectives on Access Charge Reform, Common Carrier Bureau Staff Working Paper, released April 30, 1993, pp. 16-17 [Staff Working Paper]. These changed circumstances are discussed in detail in the Staff Working Paper and numerous other industry papers and filings, and SWBT will not repeat them here.

[2] According to Dr. Joseph S. Kraemer "CAPs exist and will continue to exist because they are a tactical necessity for IXCs [Interexchange Carriers] due to the naturally competitive business relationships existing between LECs and IXCs. . . In general, CAPs

up a large share of the IXCs' operating costs, IXCs have strong incentives to use lower-priced CAPs to reduce their access charge expenses.

In the few years since their emergence following the divestiture of the Bell System, the industry has experienced a proliferation of CAP-provided networks. Based on a March 30, 1992 Telephony article, the CAP industry had evolved to at least 32 different CAPs operating in a total of 32 cities; 50% of CAP cities were served by more than one CAP; MFS and Teleport accounted for over 50% of CAP revenues with 18 networks; and Cable TV companies (who own many of the CAPs including Teleport) were involved in 50% of CAP revenues.

Many CAPs are not the inexperienced, fledgling, start-up companies that they would like the Commission to believe. Often, they are subsidiaries of larger corporate entities having considerable financial resources. As the Commission staff pointed out in its recent staff working paper on Access Charge Reform, "CAPs have also formed strategic partnerships with, and attracted major investments from, cable television companies, electric utilities, large construction firms, and other entities with extensive financial resources."[3] As illustrated in Table 1, there are at least eleven operating CAPs owned by nine cable TV companies.

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tend to be less expensive than LECs. That price advantage tends to be in the ten percent-twenty percent range for recurring services." Dr. Joseph S. Kraemer, "Market Forces Accelerate The Local Competition Revolution," February 15, 1993.

[3] Staff Working Paper, p. 18.

TABLE 1

CAP Name (cities served)	Ownership
AxS (Charlotte NC)	Time Warner and Vision Cable
Digital Direct (Chicago, Dallas & Seattle)	TCI
Eastern TeleLogic (Philadelphia)	Comcast
Hyperion Telecommunications (Jacksonville)	Adelphia and Continental
Hyperion (Syracuse, NY)	Adelphia and News Channel
Hyperion (Pittsburgh)	Adelphia
Indiana Digital Access (Indianapolis)	Time Warner (ATC)
Jones Lightwave (Englewood, CO; Chicago; Atlanta & Miami)	Jones Intercable
Kansas City Fibernet (Kansas City)	TCI & Time Warner
Phonoscope (Houston)	Phonoscope (leasing fiber to Teleport)
Teleport (Boston, Chicago, Dallas, Houston, Los Angeles, New York & San Francisco)	TCI, Cox, Continental & Comcast

Indeed, when one examines the 1992 gross revenues of the five largest access competitors of the LECs, including those of their parent/affiliated companies, those competitors actually have far greater capital resources available to them than the fourteen largest LECs combined (see Table 2).

Many feel there is a natural synergy between cable TV and the CAPs. Cable networks serve residential areas and CAPs the business areas. CAPs are looking to expand their markets by using cable TV fiber and right-of-way to reach the suburbs, thus reaching out to medium-sized customers. As cable TV revenues are flattening, cable is looking to expand revenues -- through enhanced video services and eventually through telecommunication services. John Malone, Chief Executive Officer (CEO) of TCI, the largest cable company and 30% owner of Teleport) said in 1992, "I would guess if the access market (for cable) is not a $1 billion business three years out, we're all wasting a lot of time and capital."[4]

[4] Cited by Dr. Joseph S. Kraemer, supra, n. 2.

TABLE 2

REVENUE COMPARISON BETWEEN LARGEST ACCESS COMPETITORS AND LECS

1992 GROSS REVENUES
(in billions)

LARGEST ACCESS COMPETITORS

1)	AT&T	- $64.9 b (+ $1.74 b for McCaw)
2)	MCI	- $10.6 b (+ $22 b for British Telecom)
3)	Sprint	- $ 9.2 b
4)	MFS	- $ 6.0 b (estimate includes Peter Kiewit Sons Inc.)
5)	Teleport	- $ 8.0 b (includes TCI, Cox, ComCast & Continental)

Total = $122.44 billion

TIER 1 LECS

1)	GTE	- $19.98 b
2)	BellSouth	- $15.20 b
3)	NYNEX	- $13.16 b
4)	Bell Atl.	- $12.65 b
5)	Ameritech	- $11.50 b
6)	U S WEST	- $10.28 b
7)	SWBT (SBC)	- $10.00 b
8)	Pacific	- $ 9.94 b
9)	United	- $ 2.97 b
10)	SNET	- $ 1.39 b
11)	Centel	- $ .84 b
12)	Cin. Bell	- $ .58 b
13)	Lincoln	- $ .33 b
14)	Rochester	- $ .29 b

Total = $109.11 billion

CAPs have started to make inroads into the revenue streams of the LECs.

- In New York City, where numerous CAPs are competing with NYNEX, CAPs have captured nearly 50% of the DS1/DS3 market.

- The Miami Herald reported on 12/27/92 that, "In Miami, Intermedia (a CAP) has cut into Southern Bell's phone share to the tune of thousands of dollars a year, draining big-business dollars from major Southern Bell customers, like SunBank/South Florida, Electronic Data Systems, and MCI Communications Corp."

- A July 30, 1992 Business Research Group (BRG) report states that "Corporate use of CAPs is increasing steadily" based on a BRG study of 100 companies with large data networking needs. The report stated that about 20% of the respondents use CAPs and that "on average, CAPs handle one-quarter of those users' traffic."

LECs face competitive challenges from a number of other fronts, made possible by the convergence of telephony and computer technologies. The cable industry seems to be uniquely placed to offer the strongest competition to LECs. The cable industry has grown and consolidated to the point where the top ten cable operators control about 55% of the over 55 million cable subscribers.[5] This consolidation, coupled with cable TV ownership of CAPs, has resulted in financially strong and experienced cable giants that are already present in the LECs' territories, extremely well situated to quickly become formidable competitors of the LECs for local exchange service. For example, the attached map (Attachment 1 to Appendix 1) illustrates where in SWBT's territory two major cable TV providers (TCI and Time Warner) are already

[5] Supra, n. 2. Dr. Kraemer's estimate of 55 million cable subscribers may be overly conservative, and may well exceed 60 million cable subscribers.

located today.

Cable TV companies are currently in the process of rebuilding their 20+ year-old coaxial networks into hybrid fiber/coaxial networks. Fiber will be placed to 400 - 2,000 home nodes with coaxial cable carrying the signals the last mile. This rebuilding has already started and is expected to be completed for many of the major multiple system operators (MSOs) such as TCI and Time Warner, by 1998. Some recent announcements include:

- Time Warner announced in January 1993 the creation of the "Full Service Network" which will provide a wide range of interactive information, entertainment and communications services including video-on-demand, interactive video games, home shopping and banking, distance learning and personal communications service. Time Warner expects to have four residential Orlando neighborhoods (4,000 homes) working in early 1994.[6] Time Warner substantiated this announcement in its Tenth Quarterly Report of PCS Experimental Work with the FCC, when it reported that it is "upgrading its Orlando, Florida cable system to create the world's first [emphasis in original] FSN, a fiber rich, digital system offering consumers and businesses a vast array of interactive entertainment *and telecommunications* [emphasis added] services."[7]

- TCI announced in April 1993 that it will invest $2 billion to upgrade its national cable plant with fiber optic cable within the next four years. TCI expects that 90% of its 10 million subscribers will be served by fiber before 1998.

The cable operators are rebuilding their systems as a response to several factors:

1 The coaxial trunk lines installed many years ago are wearing out and are costly to maintain. Besides, the transmission quality at the end of long cascades of amplifiers is unreliable.

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[6] "Time Warner Cable Selects First Orlando Areas For Full Service Network," Business Wire via First! by Individual, Inc. May 27, 1993.

[7] Time Warner, Tenth Quarterly Report of PCS Experimental Work, transmitted to FCC, Office of Engineering & Technology on September 14, 1993, p. 5.

2 Cable TV revenues have flattened out, creating a need for cable operators to develop new revenues sources (such as pay-per-view, near video-on-demand or video-on-demand, interactive video) -- not easily supported by the current coaxial based network.

3 Refranchising agreements are being struck with the franchising authorities asking -- and receiving -- commitments for state-of-the-art cable system technology (i.e., fiber to the node architecture).

4 Direct Broadcast Satellites (DBS), has recently obtained the ability to send hundreds of programming channels to a customer's $700 satellite dish. This has created a need for cable operators to increase channel capacity on their 36 - 70 channel systems.

Because of the tremendous bandwidth that these fiber upgrades offer, cable operators are not only looking to expand services and channels, but are also looking to the next step--offering telephone-type services. As John Malone, CEO of TCI, stated in Newsweek, "I believe I can be the low-cost provider and the earliest implementer of two-way, broadband communications. I believe I can win that race."[8]

Already many of the cable systems in the United Kingdom (U.K.) are offering telephone service in competition with the incumbent telephone company, British Telecom. Penetration of cable TV service is only 4% in the U.K.[9] compared to about 65% in the U.S., but in areas where telephone service is offered, these cable companies are reporting telephone penetrations of over 20%. TeleWest (owned by U S WEST and TCI) supplies 101,000 (over 60%) of

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[8] Newsweek, May 31, 1993.

[9] "Phone, Cable Deals Let U.S. Test Future," USA Today, June 28, 1993.

its 160,000 U.K. cable subscribers with telephone service.[10] Comcast Corp. has signed up more than 20% of its 60,000 cable subscribers to phone service in the U.K.[11] Although the U.K. situation is not directly comparable to the United States, it does show the vulnerability of incumbent telephone companies to a cable operator. A similar experience in the U.S. would dramatically impact LEC revenues and LEC ability to provide universal telephone service. Further, cable companies can be expected to offer telephone service to densely populated, higher-cost areas first, leaving the more thinly populated areas to the LEC.

In addition to upgrading its systems, the cable TV industry is also positioning itself for entry into the telecommunications business by forming alliances with telecommunications companies. Earlier this year, Time Warner agreed to a U S West purchase of 25% of Time Warner Entertainment, which owns cable franchises in 36 states, for $2.5 billion. U S West will manage the telephone service operations over Time Warner's cable systems. Richard McCormick, U S West Chairman, then stated that they intend to offer customers a "one-stop shopping source for local cable and telephone service."[12] In US WEST's

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[10] "U.K. Company News/Telewest Raises Pounds 190M To Expand Its Networks," The Financial Times via First by Individual, Inc., July 23, 1993.

[11] Mark Robichaux, "Cable-Ready - With America pretty much wired, U.S. companies begin a cable land rush overseas," Wall Street Journal, March 26, 1993.

[12] As cited in "Furtherdown the Cable: This month's news roundup," Telecommunications Review: The Gordon Report, Vol. 10, No. 6, June 1993, p. 4.

Second Quarter Report, Richard McCormick, states: "The Full Service Networks also will provide local wireline telephone service in the U.S. - a first for a regional Bell company outside its home territory." In an even bolder move, Bell Atlantic and TCI announced on October 12, 1993, that they have signed a letter of intent to merge Bell Atlantic (13 million cellular, consumer, business and government customers), TCI (10 million cable subscribers in 49 states plus international interests in cable operations in the U.K. and Europe), and Liberty Media (interest in 17 cable companies serving about 3 million customers plus extensive programming holdings). Other cable TV/telecommunications alliances include:

- BellSouth is expected to acquire 22.5% of Prime Cable (a Austin, TX based cable operator with just over 500,000 subscribers).
- TCI, AT&T and U S West are conducting a pay-per-view trial in Littleton, CO with 400 customers.
- Teleport has formed joint ventures with eleven cable TV companies (four of the eleven own Teleport) to build new competitive access services in several cities and expand existing Teleport networks in others.
- AT&T is participating in Viacom's trial of interactive video services with 1,000 Viacom customers in Castro Valley, CA.
- AT&T is providing the broadband switch for the Time Warner/US WEST "Full Service Network" in Orlando, FL.
- Time Warner and MCI teamed with First Pacific Networks to test deployment of voice over cable in Time Warner's Queens, NY cable system.
- TCI and U S West as partners are providing cable TV and telephone service in the United Kingdom and parts of Europe.
- Bell Atlantic has entered into an agreement with Sammons, an incumbent cable provider, to provide transport of its cable service over a planned fiber network in Morris County, NJ.

- Future vision, a video provider who will compete with Adelphia, the incumbent cable operator, has agreed to subscribe to Bell Atlantic's planned video platform in Dover, NJ.

- NYNEX plans to offer "video dialtone" to Liberty Cable. NYNEX will provide fiber optic cable to carry video signals for 2,000 Liberty Cable Television customers in Manhattan. Time Warner has agreed to join the venture as a way to get a look at the technology.

This scrambling for position by major industry participants is a clear indication that cable television providers will be major players in the race to provide alternate telecommunications services.

Another major force will be the fast-growing wireless industry. The wireless industry (cellular) is experiencing a phenomenal expansion -- it now has about 12 million subscribers and is growing at a 30% annual rate of growth.[13] Although most of this growth has resulted from the stimulation of a new mobility market, it would be naive to think that this growth did not have some affect on wireline telephone line growth -- whether it is the additional line market or the replacement of landlines owned by customers who prefer the mobility of wireless telephone service. As cellular rates fall, it is reasonable to expect that more wireline customers will migrate toward wireless telephone service.

Currently, there are only two cellular operations authorized for each metropolitan area. As the wireless spectrum is opened for up to seven additional operators, it can be expected

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[13] "AT&T's Deal: A Giant Steps Into New Arena," Washington Post, August 23, 1993.

that mobile rates will fall, putting additional competitive pressures on the LECs. As with cable TV, there are also many players becoming involved in the wireless arena:

- MCI formed a consortium of 150 companies to attempt to get a national (PCS) license.
- Sprint joined a consortium of international communications and industrial companies as an investor in Motorola's *Iridium* project.
- AT&T is purchasing McCaw Cellular for $12.6 billion.
- Cox Cable received a Pioneer's Preference license for its work in using existing coaxial and fiber cables to reduce the cost of deploying PCS.

Access charges are a major source of revenues for the Bell Operating Companies (BOCs). As CAPs continue to expand and enter new access markets, and as IXCs, cable TV and wireless companies are positioning themselves for entry, the LECs will be increasingly unable to meet the competitive challenge unless regulatory relief, such as that proposed by USTA, is granted. If pricing restrictions are not replaced with greater flexibility, the LECs' ability to continue to provide affordable and reliable telephone service to high cost areas will become problematic. Competitive providers do not have universal service obligations, and can serve only those areas that are the most profitable, leaving the less profitable areas for LECs to serve, while stranding millions of dollars of LEC plant

The interstate access market is unlike the market for an end user retail good characterized by many buyers. Instead, the access market is characterized by just a few very large customers, the IXCs. This observation is supported by the Commission Staff

Working Paper, which states: "Unlike the interexchange market, where demand is spread over many customers, the switched access market is much more controlled by one IXC customer and about ninety percent controlled by the top three IXC customers."[14]

If demand for a service is skewed such that the demand is concentrated primarily among a relatively small number of very large buyers, as with interexchange access services, then these buyers represent a countervailing power to the firm's ability to raise price above competitive levels. High volume customers are thought to be very price sensitive. Should a LEC attempt to raise price, or not lower price sufficiently, the potential loss of even just one of these large buyers to an alternate provider, or for them to self-provision the service as the IXCs are well capable of doing, would serve as a great deterrent to the LEC to raise price (or an inducement to lower price), because losing the large customer would result in drastic and immediate revenue declines to the LEC. In general, the fewer and larger the buyers, the more likely countervailing power will prevail, and the less likely market power can operate. In addition, if resellers are present as they are in the interexchange access market, they aggregate the demand from a number of smaller buyers and act as if they were one large buyer exhibiting similar demand characteristics as other higher volume customers.

For these reasons, the "wait-and-see-how-competition-

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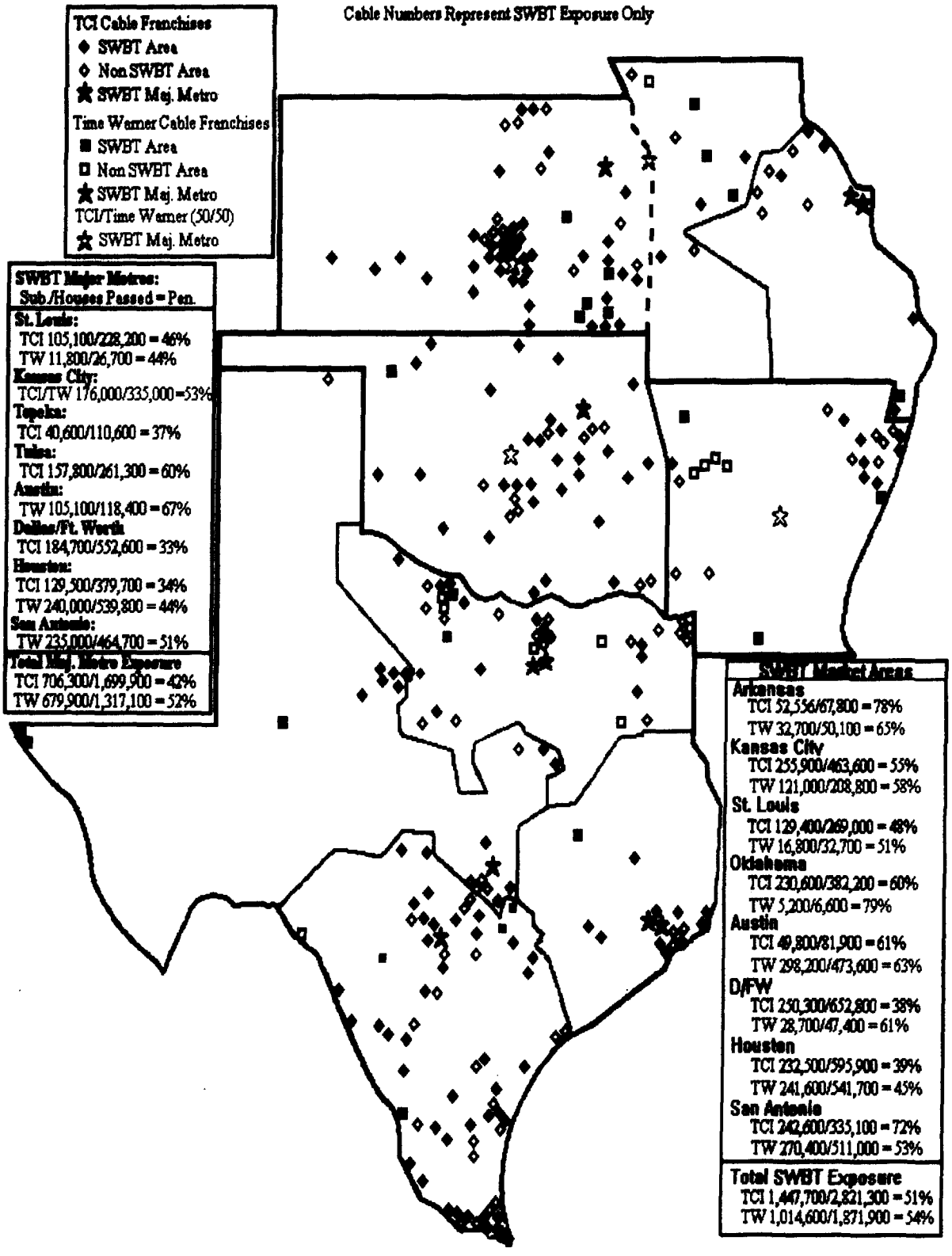
[14] FCC, Common Carrier Bureau, Access Reform Task Force, Federal Perspectives on Access Charge Reform, April 30, 1993, p. 31, n. 44.

develops" attitude proposed by some commentors may well be a prescription for disaster for the LECs. The loss of just one of the LEC's major customers in its major urban areas as a result of inaction can represent a devastating loss to that LEC. Because in markets where demand is concentrated with just a few buyers one major customer can have such a significant effect on the seller's financial well-being, competition for the few customers in that market can be expected to be fierce. Small advantages in price or product differentiation could lead to large shifts in demand, which could significantly affect the revenues of a firm. As a result, access competition can be expected to grow quickly with the implemention of the Commission's pro-competitive policies of expanded interconnection and Open Network Architecture.

TCI and Time Warner Cable Franchises

Sources: TV & Cable Factbook by Warren Publishing, cable operator announcements and telephone interviews with municipalities.

Cable Numbers Represent SWBT Exposure Only



SWBT REPLY COMMENTS
RM-8356

THE NEED FOR FACILITATING NEW SERVICES

The USTA proposal is consistent with the Communications Act of 1934, which establishes as a policy of the United States the encouragement of the provision of new technologies and services to the public.[1] The Commission has long recognized that competitive forces can further the goals of the Communications Act by best allocating society's resources, encouraging innovation and efficiencies, and generally maximizing benefits to consumers, and that unduly strict regulation of rates in competitive markets is generally not only superfluous, but harmful to the public interest.[2]

Of key importance in meeting the goal of encouraging the provision of new services is to allow such services to be developed for sale in competitive markets so that new services will be provisioned in the most efficient way, maximizing consumer benefits. This is only possible if all firms, including LECs, can bring new products to market unencumbered by regulatory restrictions, as other telecommunications service providers do today. The reasons for this are outlined below.

In the LEC Price Cap plan, the Commission defined new services as those which add to the range of options available to customers. By the Commission's own definition, new services

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[1] Communications Act of 1934, 47 U.S.C. § 157(a).

[2] In re Competition in the Interexchange Marketplace, Notice of Proposed Rulemaking, FCC, Docket No. 90-132, released April 13, 1990, para. 97. [LD Competition]

increase the range of alternatives available to consumers while maintaining all the service options available to consumers before the new service was offered.[3] Consumers, therefore, can be made no worse off with the introduction of a new service than they were before the service was introduced, regardless of the price that is charged for the new service.

If a provider charges prices for new services that are too high, very few, if any, customers will buy the services. The provider would then have to lower prices, or discontinue the products if it could not cover its costs. In neither case would customers be worse off than they were before. But if the provider could offer a new service at a price which would stimulate sufficient demand to generate a profit, then those customers choosing the new service would be better off -- otherwise they would not choose the new service, but keep their existing service arrangements. Customers can only be made better off by the successful introduction of a new service, regardless of who provides it and at what price. Therefore, the LECs should be able to introduce new services unencumbered by regulatory constraints, as their competitors do, with competitive market forces determining the proper price.

In the short run, a LEC, or any other firm, may be the sole provider of a new service and may be able to charge a relatively high price, achieving higher returns from this new service than from its general operations. These short-term higher

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[3] LEC Price Cap Order, para. 314.

profits allow the LEC to recover some of the research and development costs incurred in bringing the new service to market, and act as an entry signal to other firms, providing an incentive for competitors to develop alternatives to this new service. As alternatives become available, the market price will fall and the LEC's (or other initial provider's) temporarily high profit margin will shrink. Competitive market forces will thus preclude the LEC from earning higher profits over an extended period of time, rendering price regulation unnecessary.

Examples abound of how competitive market forces work to develop competitive new services. Consider the development of the markets for electronics, or for personal computers: personal computers were initially introduced at extremely high prices, compared to today, but as other firms began to offer their own versions of personal computers, market price dropped and the innovating firm had to lower its prices to keep sales. This process continues today. With personal computers available at a great variety of retail outlets, consumers today can buy new versions of much faster computers for the same price as they previously paid for the much slower machines available just one or two years ago. This is the essence of competitive markets, which can only be realized if <u>all</u> providers are allowed to participate in the competitive process unencumbered by regulatory restrictions.

In fact, control of prices in potentially competitive markets may in the long run hinder the development of competition. If prices and profits are kept low by regulators, the market does

not send out adequate entry signals. Potential entrants may choose to invest their resources in other, more profitable ventures, and the resources that would spur the development of product improvement and innovation characteristic of competitive markets are not brought to the market.

Second, developing a new service often entails considerable research and development costs, and substantial uncertainty regarding a great number of factors, as outlined in the USTA Petition.[4] There are a host of factors that are uncertain throughout the development process. As USTA states, the more innovative the new service is, and the more it relies on unproven technology and uncharted markets, the greater the risk of product failure or falling short of product expectations. Sometimes, product failures are recognized early in the development process, sometimes only after substantial resources have been invested. If the product fails, the firm has to pay for the development costs from other sources. Thus, product development can be very risky because it can be very costly and there are no guarantees of product success.

Firms will undertake such risky investment only if they can reasonably expect to earn a healthy financial return from the product, at least in the short-run, until other firms begin to

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[4] USTA lists these questions: Will there be unexpected snags that will lead to higher than anticipated actual production costs? Will there be sufficient demand for this product? Can the product be developed within the "window of opportunity" time frame? Will the new product be as reliable when implemented as it was under testing? USTA Petition, pp. 36-37.

compete for the service and the market price falls to a level that leaves firms with only normal returns. Thus, substantial profits in the short-run, following the introduction of a new service, are reasonable as a reward to the provider of the new service for undertaking the risk and research and development expenses necessary to bring a new service to the market. Precluding the firm from earning relatively high profits in the short-run would diminish the firm's incentive to undertake the risks of research and development of new services. This fact was recognized by the Commission in concept when it allowed new services to remain outside the price cap formulas for a brief time.[5]

Although the FCC recognized that pricing flexibility for new services "will strengthen carrier incentives to innovate,"[6] the constraints associated with price cap regulation of new services substantially reduce these incentives because they severely dampen the rewards for undertaking risky and potentially costly innovation. In short, it is the prospect of earning higher returns on new services for some short period of time, until competition develops, that provides an incentive to undertake research and to innovate. The USTA proposal for streamlining new service introduction is consistent with this phenomenon and provides the correct incentives to foster research and innovation. On the other hand, subjecting the earnings from new services to sharing under price cap regulation greatly reduces or eliminates the incentives

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[5] LEC Price Cap Order, para. 319.

[6] Id.

to innovate and assume the risks of product development.

Finally, the existing access structure rules prevent the regulated new service provider from designing its new service to meet market needs. The structural problems created by Part 69 under rate of return regulation were incorporated into price cap regulation with the establishment of price cap baskets and service categories on a service application basis (*i.e.*, switched v. special). Part 69 also codifies the rate structure for switched access services. This presents problems when new services are developed that have aspects of both applications. As USTA points out,[7] such services do not readily fit the switched or special access service definition, and fitting them into either of these baskets distorts the LEC's ability to properly price and market the service. In addition, it can require that the LEC obtain a waiver, which, contrary to MCI's assertion, is costly, time consuming and uncertain. Sprint finds that the average processing time for new services, as specified in USTA's Petition, is currently 7.4 months (p. 3). A seven-month delay is unreasonable and denies customers the responsiveness that the Communications Act requires. With rapidly changing and converging technologies, new services increasingly will no longer fit applications-based classifications. Instead, new services should be offered outside price cap regulation, and on a functional basis, to reflect the underlying technology and service functions when marketing and pricing the new service.

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[7] USTA Petition, p. 15.

CERTIFICATE OF SERVICE

I, Joseph Meier, hereby certify that the foregoing "Reply Comments Of Southwestern Bell Telephone Company", in Docket No. RM 8356, has been served this 16th day of November, 1993 to the Parties of Record.

Joseph C. Meier